

# TRANSACTION GOVERNANCE AND CONTRACTUAL RELATIONS IN A TRANSITION ECONOMY: THE CASE OF UKRAINE

Olga N. Nashchekina<sup>1</sup>, Igor V. Timoshenkov<sup>2</sup>

<sup>1</sup> *Department of Management & Engineering, National Technical University "Kharkov Polytechnic Institute", 21 Frunze St., Kharkov 61002, UKRAINE\**

<sup>2</sup> *Operational & Financial Management Department, Kharkov Institute of Humanities «People's Ukrainian Academy», 27, Lermontovskaya St., Kharkov 61000, Ukraine*

---

## Abstract

*The characteristics of a transitional institutional environment are identified and their implications for contractual relations are discussed. Empirical results illustrative of the peculiarities of the Ukrainian business environment and contractual relations in the Ukrainian small business are presented. The interplay between formal and informal arrangements in contractual relations is analyzed. The role of different types of trust in transaction governance is discussed.*

---

## 1. Introduction

More than a decade has passed since planned economies of Central and Eastern Europe stepped on the path of the transition to the market. Yet, to make the market mechanism function successfully, supporting institutions are required. These institutions include in D. North's terminology the formal rules of the game and informal constraints, and their "...major role in a society is to reduce uncertainty by establishing a stable...structure to human interaction" [1]. The transaction cost approach [2] provides a convenient framework for the explanation of the role of institutions: the numerous institutions help to reduce transactions costs associated with exchanges between economic agents.

Under the transition, the old institutional matrix becomes disintegrated, whereas new institutions have not been worked through yet, thus transaction costs in emerging market economies must be inevitably high.

---

\* e-mail: [nashon@kpi.kharkov.ua](mailto:nashon@kpi.kharkov.ua); [nashchekina\\_olga@yahoo.com](mailto:nashchekina_olga@yahoo.com)

A discontinuous institutional change associated with the transition and subsequent frequent incremental adjustments of institutions through the trial-and-error method require corresponding adaptations of transaction governance structures. In accordance with the transaction cost approach, choosing a certain contracting scheme will be aimed at satisfying the condition of transaction cost minimization [2].

The focus of this paper is on the specificity of contractual relations under the transition with the special reference to the Ukrainian transitional economy, particularly on a complex tangle of formal and informal arrangements governing transactions in the Ukrainian small business.

The paper is organized as follows. In the second section, we discuss the major characteristics of a transitional environment, their effect on the transaction cost level and implications for contracting. In the third section, we present some empirical results illustrative of the peculiarities of the Ukrainian business environment and contractual relations in the Ukrainian small business. More specifically, we show how the Ukrainian business environment is assessed by entrepreneurs and analyze the role of the formal and informal institutions in governing contractual relations. A special emphasis is placed on the role of trust and reputation in economic exchanges.

Empirical part of the analysis is based on the data from a survey of small business owners conducted in 1999 in Kharkov, a big industrial city in Eastern Ukraine. The sample consisted of 190 entrepreneurs. The survey data were collected through personal interviewing of respondents using well-structured questionnaires. The significance of the observed differences was tested using Z- and t-statistics at two levels of significance ( $\alpha = 0.05$  and  $\alpha = 0.01$ ).

## **2. Institutional Environment and Its Effect on Contracting Modes in a Transition Economy**

From the institutional point of view, the transition is associated with a radical change in the formal rules guiding the social life in a society. However establishing a new institutional matrix with a harmonic unity of all three dimensions described by D. North [1], namely formal rules, informal constraints, and the effectiveness of their enforcement, is at best a long term perspective. In the short run, incoherency and instability are the most salient attributes of transitional institutions. Under a discontinuous institutional change many parameters of the institutional matrix change simultaneously, and it takes time to "bind the loose ends together" and make the system run smoothly.

Thus, the primary role of institutions consisting in reducing uncertainty and providing stability of human interactions, thus reducing transaction costs of economic exchanges, diminishes during the transition. Insufficient constraints for opportunistic action make cooperation riskier and limit realization of potentially beneficial exchanges.

The specificity of the transitional institutional environment determines the patterns of contracting in a transition economy. Ambiguity of laws and regulation procedures, inadequate legal support in contract enforcement make economic agents place more emphasis on private ordering procedures and other informal ways of solving disputes [3, 4].

Informality in governing transactions is associated with relational modes of contracting. It is more common to evoke the concept of relational contracting when a complex long-term transaction with an uncertain outcome is under consideration. However a high degree of environmental uncertainty will affect the choice of a contracting mode in the way similar to that in which such transaction attributes as complexity and uncertainty do.

The very concept of a short- and long-term transaction must differ for relatively stable and rapidly changing environments. What can be considered in a more stable environment as a short-term transaction, in an environment prone to frequent changes will be a long-term one and consequently will require a corresponding contracting scheme. The governance structures for short-term transactions in an uncertain environment will resemble in some ways those for long-term transactions in a more stable and predictable environment. Environmental uncertainty makes writing more complete contracts costlier *ceteris paribus* and/or increases ex ante/ex post negotiation costs. Under these conditions, relational contracting may be more appropriate for transaction costs reduction.

Another aspect of the transitional environment, namely an inadequate third party support in contract enforcement might also call for relational rather than classical or neoclassical contracting. There is an observation that societies involving fewer recurring exchanges between the same parties need to rely on formal institutions to promote cooperation, and when the probability of continuation is high—i.e., the society is predominantly characterized by long-term relationships—informal arrangements become viable mechanisms especially when contracting costs are also high, which diminishes individuals' willingness to employ contracts unnecessarily [1]. The game theoretical predictions and recent experimental contributions (see for example [5]) support this idea. Environmental uncertainty, characteristic of the transition, narrows horizons of planning and thus diminishes the expected number of repetitions of the game which seems to lead to a stronger reliance on formal agreements. However, in the absence of an adequate third party support in the contract enforcement, the role of informal arrangements can be expected to become more significant.

Informality in contractual relations is associated with trust between the parties to the transaction. The issue of trust in business relations has moved central-stage in many contributions due to the role trust plays in reducing transaction costs. There are also a number of macro-level studies, which empirically show the effect of trust on economic performances [6, 7].

Trust is a very elusive concept to define and to analyze due to its multifacetedness. However, numerous contributions to studying trust both historical and more recent (see for example, [8-14]) lend some insight into the nature of this phenomenon, its types and dimensions. Trust can be defined as “..a mutual expectation that partners will not exploit the vulnerabilities created by cooperation” [13]. For the present analysis we will contrast two different types of trust, which are personal trust and system or institution-based trust. Personal trust is likely to develop when individual actors frequently have face-to-face contact and become familiar with each other's personal preferences and interests without substantially taking recourse to institutional arrangements [8]. On the other hand, “..in the course of time multiplicity of institutions has developed whose effect is to reduce the scope for opportunism and to foster trust between potential partners” [14]. “..Most trust-creating institutions restrict the ability of individuals to break promises, either by compelling them to keep these promises or by imposing some penalty if they do not..” [14]. Thus, reducing the risk for trusting behavior institutions can enhance trust not in a particular person but rather in a faceless potential partner, and this what is referred to as system trust.

It is clear that when the personal trust is present in contractual relations the exchange is personalized. It is equally clear that building such trust relationship is very costly, and only after investing a significant amount of time, money, energy into building such relationship can one realize the benefits in terms of transaction cost reduction coming from informal arrangements. On the contrary, the system trust does not require the personalization of

contractual relations, allowing the parties at the same time take advantage of informality in business agreements. Under the conditions of a patchy and incoherent institutional framework, it is the personal trust that matters more for informal arrangements, which determines additional costs of building the relationship. For long-term complex uncertain transactions involving a high degree of asset specificity and situations when a number of potential partners is limited these costs would be justified. For simple transactions, which do not assume much of asset specificity and the number of potential partners is plentiful, costs associated with building personal trust must become a real burden, and once the investment into the relationship is made, the parties are tied to each other because exit and building a new relationship might be associated with additional substantial costs. The implication is obvious if it is costly to break the ties and switch to a more efficient partner, the efficiency of exchanges might suffer.

It is also necessary to mention that not only does the transitional institutional matrix fail to make a significant contribution into transaction cost reduction but the institutional matrix itself due to its instability and ambiguity becomes an additional source of transaction costs. High costs of compliance with the regulation may crowd business out to the "shadow". Retreating from the realm of formal institutional framework leads to a greater degree of informality in contractual relations and, in particular, in contract enforcement. As M. Turvani concludes from her analysis of illegal markets “..Prohibition cancels the possibility of referring to a higher, more formal level of institutional orders and sanctions.. Transactions will take place, but they are now pushed back to another, more primitive institutional environment... A black market is a market with a lower degree of institutionalization protecting agents and their transactions” [15].

In some cases the concept of informalization may encompass interactions of economic agents with the formal institutional matrix itself in the form of bending of existing formal

rules [16]. Detailed discussion of this phenomenon is beyond the scope of this paper, however we will present some empirical evidence related to it.

Thus, under the conditions of a transitional institutional environment incapable of providing a sufficient support in contract enforcement, more stress in contractual relations between economic agents will be placed on informal arrangements. Frequent changes in the institutional environment will raise probability of ex post contract term adjustments and thus will call for relational contracting modes even in the case of simple, relatively short-term transactions. Informal arrangements and relational contracting schemes are possible when based on trust between the parties to the transaction. Under the deficiencies of transitional institutions, personal trust must play a greater role.

### **3. Empirical Evidence from the Survey of Ukrainian Small Businesses**

#### **3.1. Institutional environment as assessed by the entrepreneurs**

Here we present some empirical results from the survey of the Ukrainian small business owners, which portray the Ukrainian business environment as viewed by the entrepreneurs.

The respondents were asked to assess how favorable the Ukrainian business environment was for the small business operation in general and for the operation of their own enterprises in particular, using a 5-point scale with “1” corresponding to “very unfavorable” and “5” to “very favorable”. The mean for “Favorability in general” was 2.1 and for “Favorability for own enterprise” 2.7 (error did not exceed 6 %). The frequency distributions of answers are given in Figure 1 a.

As is seen, the business environment was perceived to be more favorable for the own enterprise than for the small business operation in general. The observed statistically significant difference between the means can be attributed to i) a bias or prejudice against existing institutions; ii) a choice of business which is less susceptible to the negative effect of the environment, and/or iii) successful adjustment to the hostile institutional environment. The latter can mean an informal “correction” of the official rules of the game, e.g. alleviating of excessive regulation by establishing personal relations with officials controlling entrepreneurial activities.

The results of the evaluation of the risk for small business functioning in Ukraine in general and the risk for own business operation were rather similar to those of environment favorability assessment. The “Risk for small business in general” was viewed on average to be higher than the “risk for own enterprise” (Figure 1b). Underlying reasons can be similar to those discussed above.

The results of respondents’ assessment of the importance for them of separate sources of risk using 7-point scales are presented in Figure 1c. As is seen, the main sources of risks for small business development are related to the institutional factors (taxation policy, regulation) and changes in economic situation rather than to market processes – competition, fluctuations in demand, etc. Thus, the Ukrainian institutional environment remains the major source of risk and impediment for small business operation and development.

To get further confirmation of the idea of the formal rules “informalization”, the respondents were offered the following series of Likert-scale questions:

1. “To run business successfully, one should establish connections with the regulating authorities”
2. “Entrepreneurs working in the Ukrainian small business often have to violate laws”



3. “For Ukrainian entrepreneurs, retreating to the “shadow” is the only way to survive in business”

Taking into consideration a delicate nature of these questions, the respondents were asked to express “their opinion regarding small business in general, not necessarily their own approaches to running business”.

Measured on 7-point Likert scales with 1 as “fully agree”, 7 as “completely disagree”, and 4 as a neutral point, the means were 2.2, 2.3 and 2.9 for questions 1, 2 and 3 respectively, which indicates rather high degree of agreement with the statements. The frequency distributions of the answers are given in Figures 2 a,b,c.

Establishing personal links with the regulatory authorities can be considered as an attempt to acquire some degree of control over activities of these agencies, and thus to make an immediate institutional environment less hostile.

The Ukrainian business environment can not be described as supportive not only because of regulation but also due to unsatisfactory business infrastructure (financial, informational, legal). According to our results, 74 % of the respondents use no external financing at all. The rest have to resort mainly to so-called non-market financial institutions [17] - around two thirds of credits come from informal sources (Figure 8). Lending by official financial institutions such as banks is not popular under the conditions of a high uncertainty about the future developments and with poor possibilities of monitoring and tracking borrowers' credit histories. Higher risks lead to higher interest rates, which are not affordable for many small business owners. So, the majority of those using external financing receive it within a circle of familiar people. The system is though workable but obviously inferior to that related to official or “market” financial institutions as having a very low potential for promoting economic growth.

Availability and adequacy of the legal support will be discussed in the next section.

The low quality of the institutional environment has implications for governance structures of transactions taking place in that environment. Although we do not establish explicit (quantitative) links between the environmental factors and characteristics of the governance structures, qualitatively the implications seem rather obvious and are commented on in the discussion that follows.

### **3.2. Contractual relations in the Ukrainian small business: interplay between formal and informal institutions**

In this section we will empirically explore patterns of contractual behavior in the Ukrainian small business that help to minimize transaction costs within the given institutional environment.

#### **3.2.1. Choice of business partners, informal networks and personalization of exchanges**

In section 2, it was already mentioned that when an institutional framework fails to provide an adequate support for economic exchanges, economic agents will more actively have a recourse to relational contracting modes even in the case of simple, short-term transactions. Relational contracting implies personalization of economic exchanges.

The survey results show that the identity of business partners in the Ukrainian small business does matter. On average more than 50 % of overall business contacts of the respondents were established with people they knew personally; over 30 % of contacts were established with people known by recommendation and less than 20 % of business relations were started with earlier unknown people. Approximately 17% of respondents never deal in business with unfamiliar people.

Informal networks play an important role in the Ukrainian small business. They allow entrepreneurs to reduce transaction costs due to better possibilities of monitoring and help to partially lift the informational problem when locating trading partners. According to the respondents, informal networks represent main source of information on reputation of potential business partners leaving mass-media, research agencies and other official sources of information well behind from the point of view of both frequency of their using and their reliability.

The advantage of dealing with familiar people consists in the fact that investments in the information about a potential business partner's personality has been already made (sometimes long before the contractual relationship starts), and there is no need to incur additional transaction costs. The same reasoning can be employed to explain a certain rigidity in the process of switching from a well-known partner to a new one. The less information about potential partners is available and the less effective the institutional support in contract enforcement is, the more rigidity will be associated with choosing/changing business partners.

In the Ukrainian business, partners are usually heavily invest in personalizing relations. The respondents from the survey were asked about how important for them to establish informal relations with the business partner and to win his/her benevolent attitude. The frequency distribution of their answers is shown in Figure 3 together with another distribution reflecting how often they undertake steps to establish such relations. As is seen from the distributions, entrepreneurs consider building personal relations with business counterparts rather important. The reasons underlying the attempts to personalize exchanges are different. Equally important (at least the differences were statistically insignificant) were the following reasons: "to secure higher responsibility of the business partner", "to increase predictability of the partner's behavior", "to get better idea about the partner's personal

qualities”. “Making interaction more pleasant” was considered less important (the difference was statistically significant).

Another interesting result of the survey, which further underscores the importance of the identity in business relations, is related to the reputation of potential partners. The respondents were asked to estimate importance for them of personal reputations of prospective business partners and reputations of their firms as legal entities using a 5-point scale with 1 as “extremely important” and 5 as “unimportant”. The results showed that personal reputations matter more than those of legal entities: 1.8 vs. 2.2, with the difference statistically significant. This shows that exchanges in small business are highly personalized. When a business agreement is not adequately supported by formal institutions, sticking to the agreement terms greatly depends on personal characteristics of the parties.

Another reason for relying more on the personal reputation can be connected with short life-cycles of firms working in an unstable and hostile business environment. Firms appear and disappear but people remain, that is why the personal reputation is a more meaningful indicator and basis for starting business relations. However, the two types of reputation are closely related.

### **3.2.2. Breach of contract terms: reasons, responses, safeguards**

The situation in the Ukrainian economy is often referred to as a “crisis of contractual relations”, which manifests itself through different types of contract terms violations. This problem is also relevant for small business.

In our survey, we attempted to reveal reasons for the violation of contract terms and to rate them according to their frequency (Figure 4 a). The most frequent reason is “circumstances beyond the business partner’s control”. Unforeseen contingencies resulting from changes in an unstable environment are the main causes of contract term violations.

However, if changes in business environment are frequent and affect the performances of parties to transactions, there can arise temptation to benefit from violating contract terms under the pretext of unfavorable external circumstances without a damage for reputation. And here, the above discussed informal networks and personal relations may prove helpful in providing closer monitoring.

The rest of the reasons are related to the business partner's characteristics. Irresponsibility of the business partner was rated as the second most frequent reason of contract term violations. The fact that this reason is cited so frequently means that the incentives for more responsible behavior are sufficient. A possible explanation is the lack of competition, especially when choice of business partners is confined to a small network.

To reduce the risk of contract term violations, entrepreneurs use the following safeguards. The most popular is prepayment. It is followed by "dealing with familiar people", "careful writing of the contract" and "gathering maximum information about personality and capabilities of the business partner". The latter three measures are almost equally popular though related to rather different approaches to building business relations. Dealing with familiar people implies possibility of a higher degree of informality in business relations while careful writing the contract assumes building these relations on more formal basis.

The informal mechanism of contract enforcement is more typical for informal networks where the information on reputation is easily available and community enforcement plays an important role. However, contractual relations are not reduced to informal agreements but rather represent a mixture of formal and informal arrangements.

### **3.2.3. Complementarity of formal and informal arrangements in contractual relations**

It is known that opportunism can be reduced by contract law, obligations of an ethical or trusting nature, or reputation [18]. These mechanisms of protection from opportunism are

not incompatible, on the contrary "formal arrangements such as written contracts are employed jointly with informal dealings to support diverse types of exchanges.." [5].

Probabilistic hold-up framework, proposed by Klein, "implies a fundamental complementarity between court enforcement and private enforcement" [19]. The necessity of combining formal and informal means of contract enforcement stems from the fact that "..private enforcement capital is limited.." and ".. transactors can be expected to use written contract terms and, hence, the assistance of the court, as a supplement to private enforcement"..[19].

Our results also support the view that there is a sophisticated tangle of formal and informal arrangements in business agreements. The mix of arrangements must depend on the characteristics of the institutional environment in which the transaction is carried out and also must be idiosyncratic to the particular relationship between the contracting parties.

As is seen from Figure 4 b, the most popular measure used for settling disputes arising from contract term violation is re-negotiation of the contract terms. It appears rather sensible if the main cause of violations is circumstances outside business partners' control. Litigation, as a means of contract enforcement, was considered by the respondents as the least popular measure. These results are consonant with those reported in [3].

Thus, private ordering is more typical for governing transactions in the Ukrainian small business than appealing to courts. The system of legal support was evaluated by the respondents rather critically (Figure 5 a). Only 20 % of respondents had had previous experience in enforcing contracts through courts. At the same time, and this is an interesting observation, their opinion on the effectiveness of the legal support was on average higher than that of the rest of the sample.

It should be noted, however, that though a great number of respondents valued existing legal support as rather ineffective, they showed a very moderate interest in its

improvement (Figure 5 b), which might be an evidence of their relying more on other means of business agreement enforcement.

To find out to what extent the respondents relied upon formal and informal agreements in their business relations, we asked them to divide 100 % between formally written documents, which could be used in the court for contract enforcement and informal verbal agreements backed up by the partner's reputation and other means of contract enforcement. The relative importance of formal and informal agreements was different for different respondents varying from the reliance exclusively on formal agreements to the absolute preference of informal ones. However, on average the respondents claimed to rely more on formally written documents than on informal agreements in the proportion 56 %: 44 %, the error of determination not exceeding 8 %. This result seems somewhat surprising because according to the survey data, the percentage of respondents who had an experience with litigation is very low despite the frequent contract term violations. Besides, the respondents did not exhibit much interest in improving the legal support system. It might mean that the need for the improvement of the legal assistance in contract enforcement is a better proxy for judging about how much stress is put on formal and informal agreements. On the other hand, it might be a further evidence that formal and informal arrangements are complementary to each other. Anyway, the interplay of formal and informal arrangements is not simple and straightforward one.

Besides, as B. Klein asserts "... when contracts are not costly, individuals may be tempted to use these instruments even when informal agreements alone are self-enforcing.." [19]. That is exactly our case. Formal agreements governing simple transactions, which are prevalent in small business, are not costly. They are incomplete anyway, but the subject of transaction and its result are clear and certain.

Finally, although the respondents did not show much confidence in litigation, they might believe that for a partner prone to opportunistic behavior it represents a credible threat. If not the punishment itself in the form of full compensation of the other party's losses, at least the engagement in time-consuming legal procedures and possible costs of affecting impartiality of the third party, may deter opportunistic behavior.

### **3.2.4 Trust as the basis for cooperation: does integrity interfere with competence?**

As trust is a multifaceted phenomenon, there are different typologies of trust. In Section 2, we discussed the difference between personal trust and system trust [8, 12].

It is personal trust that plays a greater role in the Ukrainian small business. In a view of frequent contract term adaptations, informal adjustments of contact terms would help to minimize both ex ante and ex post transaction costs. Besides, the deficiencies of institutional support in contract enforcement will call for private ordering where the identity of the partners will matter. As was shown above, Ukrainian entrepreneurs place more emphasis on personal reputations of business partners than on reputations of legal entities and prefer to carry out transactions with familiar people. Although such approach is justified at the micro-level from the point of view of transactions costs minimization, it certainly imposes limitations on overall economic development. As N.Luhmann notes “..the lack of confidence will lead to feelings of alienation, and eventually to retreat into smaller worlds of purely local importance..”[20].

The problem with personal trust is that “..it takes tremendous amounts of time and effort to establish it and thus can not be deemed a very efficient way of coordinating economic transactions within complex socio-economic systems... Today trust based on individual actors' integrity can only fulfil a supplementary function, compared with trust produced by institutional arrangements..” [12].



To further elaborate on the issue of trust in business relations, we will look at it from a different perspective. As R. Rowthorn notices, "...if we hire someone, take job or collaborate in a business venture, we are interested in the abilities and intentions of the other parties. Intentions alone are not sufficient, since our partners may be willing and honest, but mistaken about their abilities..."[14]. Drawing on the ideas from [13, 14], for the purposes of our analysis we will distinguish between trust in the intentions and trust in the competence of a business partner.

In accordance with the above presented rating, the third most frequent cause of contract terms violation is insufficient qualification and incompetence of the business partner. The reported frequency of intentional violation of contract terms is low in comparison with other causes, which can be due to a careful choice of business partners within the informal network. To all appearances, personal honesty comes before professional qualifications. In other words, it is trust in intentions of the potential business partner that plays more significant role in business relations in the Ukrainian small business, while the lack of competence is tolerated more readily. Clearly, such an approach limits the competition and inhibits growth in business performances.

Contrary to that, in economically developed societies, a greater stress is put on professional qualifications and performances of business partners, which, in turn, is determined by a wider choice of business partners (not only within small informal networks) and, consequently, higher competition; more reliable sources of information on potential business partner's reputation. Stable environment and effective institutions limit possibilities for opportunism.

## Conclusions

To summarize, the empirical study of contracting under the transition was aimed at showing the peculiarities of contractual relations in the Ukrainian transitional institutional environment, whose incoherency and instability increase costs of transacting and affect contracting modes that parties to transactions choose.

It is shown that business relations are built and maintained within informal networks, which helps to reduce transaction costs under the given constraints. However, the confinement to informal networks narrows choice of potential business partners and limits competition and incentives for improving business performances. Therefore, it is honesty of potential business partners that is better secured within informal networks than the partners competence.

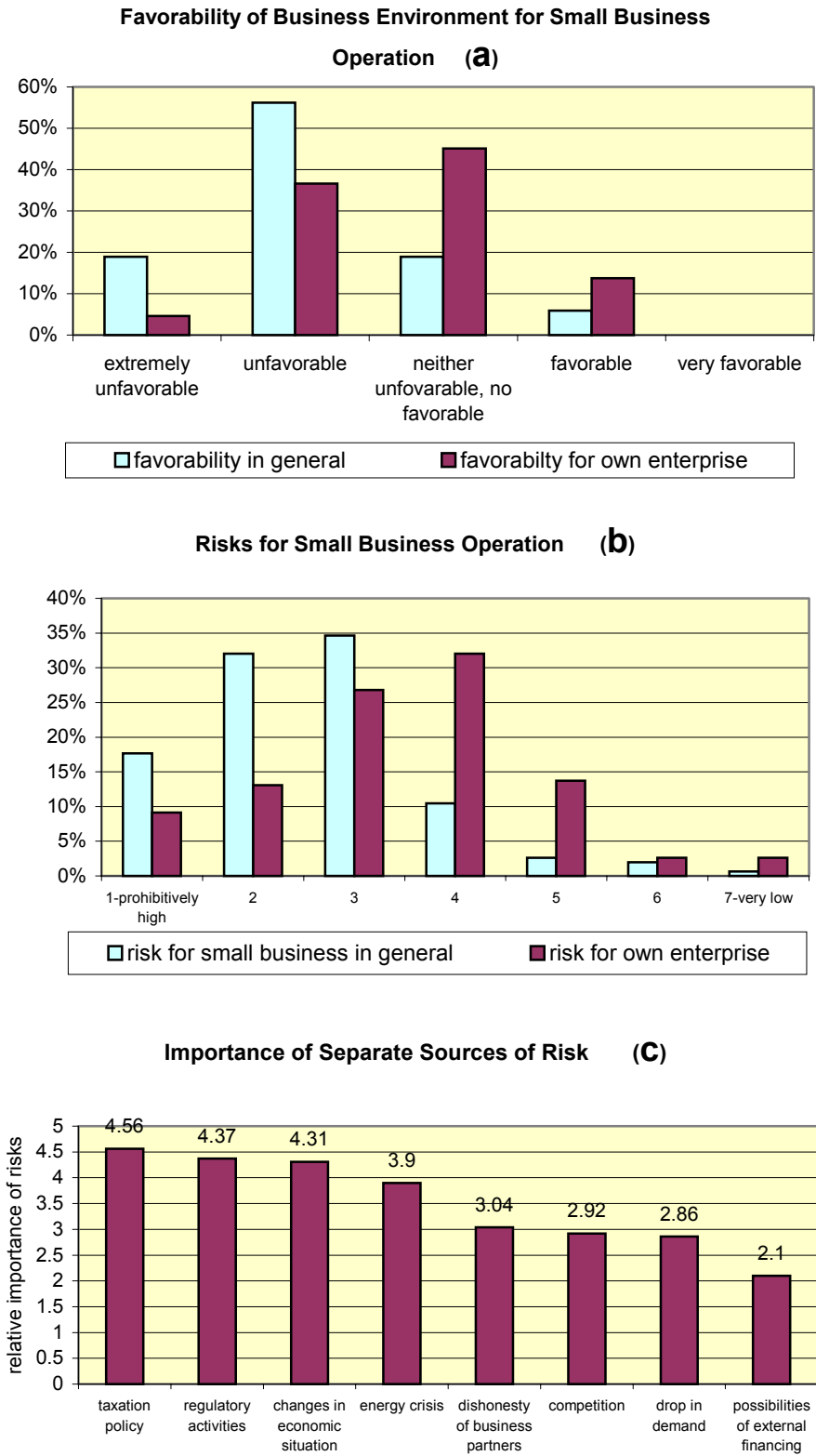
Frequent changes in business environment, which account to a great extent for a high rate of contract term violations, necessitate frequent adjustments of business agreement terms and that is why require relational contracting schemes even for simple short-period transactions. Private ordering is normally preferred to legal procedures. It is flexible relational contracting schemes that allow transacting parties to keep transaction costs at minimum.

It is also shown that personal trust plays a much more significant role in business relations than system trust. However, the latter is a necessary condition for a successful economic development and growth.

## References

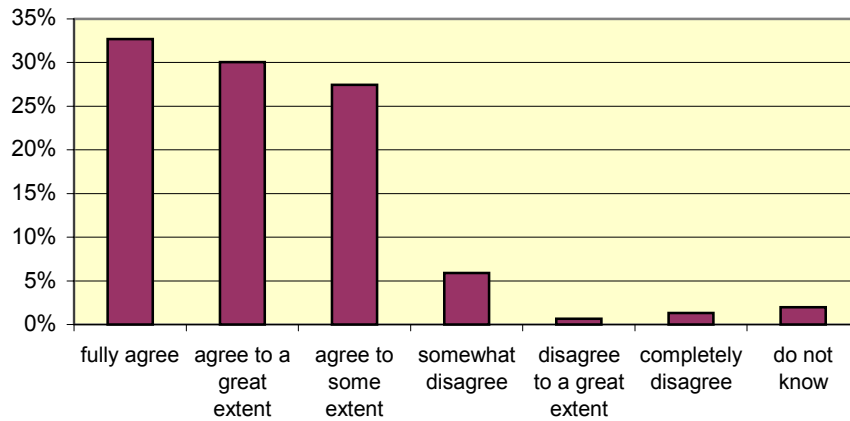
1. D. C. North, *Institutions, Institutional Change and Economic Performance*. Cambridge: University Press, 1990.
2. O. Williamson *The Economic Institutions of Capitalism*. New York: Free Press, 1985.
3. J. McMillan, C. Woodruff, *Dispute Prevention Without Courts in Vietnam* // *The Journal of Law, Economics, and Organization*, 1999, V. 15, N 3, P. 637-658.
4. J. McMillan, C. Woodruff. *Private Order under Dysfunctional Public Order* // *Michigan Law Review*. 2000. Vol. 98. P.2421-2458.

5. S.G. Lazzarini, G.J. Miller, T.R. Zenger, Order with a Little Bit of Law: Complementarity vs. Substitution of Formal and Informal Arrangements, Working paper, Olin School of Business, Washington University in St. Louis.
6. Knack S. and P.Keefer. Does Social Capital Have an Economic Payoff? A Cross-country Investigation // Quarterly Journal of Economics, 1997. November, P.1251-1287.
7. P.J.Zak and S. Knack, Trust and Growth // The Economic Journal. V. 111 (April), 2001, P.295-321.
8. R. Bachmann, Trust, Power and Control in Trans-Organizational Relations // Organization Studies, 2001, V. 22, N 2, P. 337-365.
9. O. Williamson Calculativeness, Trust, and Economic Organization // Journal of Law and Economics, 1993, V. 36, P.221-270.
10. "Trust and Economic Learning", ed. by N.Lazarcic and E. Lorenz, Edward Elgar, 1998
11. "Trust: Making and Breaking Cooperative Relations", ed. by D.Gambetta. Oxford: Basil Blackwell, 1988.
12. L. G. Zucker, Production of Trust: Institutional Sources of Economic Structure // Research in Organizational Behavior, 1986, V. 8, P.53-111.
13. M. Sako "The Information Requirements of Trust in Supplier Relations: Evidence from Japan, Europe and the United States", in "Trust and Economic Learning", ed. N. Lazarcic and E. Lorenz. Edward Elgar, 1998.
14. R. Rowthorn, Marriage and Trust: Some Lessons from Economics // Cambridge Journal of economics, 1999, V.23, P. 661-691.
15. M. Turvani, Illegal Markets and New Institutional Economics in "Transaction Cost Economics. Recent Developments", ed. by C.Menard. Edward Elgar, 1997.
16. V. Radaev, Informal Institutional Arrangements and Tax Evasion in the Russian Economy // Paper presented at the 5 the Annual Meeting of International Society for New Institutional Economics (Berkeley, USA, 13-15 September 2001)
17. T. Besley. Non-market Institutions for Credit and Risk Sharing in Low-Income Countries // J. of Economic Perspectives, 1995, V.9, N 3, P.115-127.
18. Chong Ju Choi, Soo Hee Lee, Jai Boem Kim, A Note on Countertrade: Contractual Uncertainty and Transaction Governance in Emerging Economies // Journal of International Business Studies, 1999, V. 30. N 1 First Quarter, P.189-202.
19. B. Klein, Why Hold-ups Occur: the Self-Enforcing Range of Contractual Relationships // Economic Inquiry, 1996, V. XXXIV, P. 444-463.
20. Luhmann N. Familiarity, Confidence, Trust: Problems and Alternatives, in "Trust: Making and Breaking Cooperative Relations", ed. D.Gambetta. Oxford: Basil Blackwell, 1988.

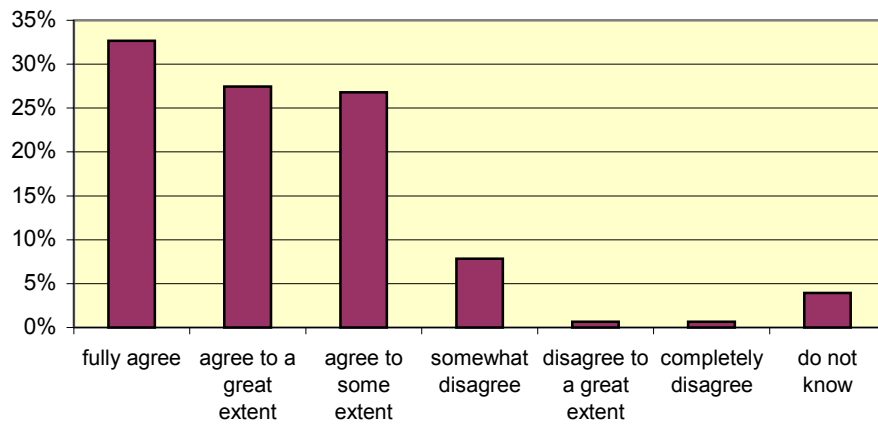


**Figure 1**

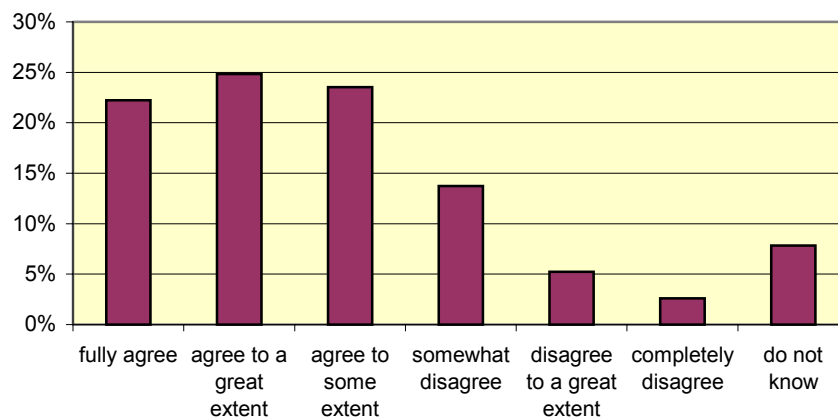
**"To run business successfully, one should have connections with the regulating authorities" (a)**



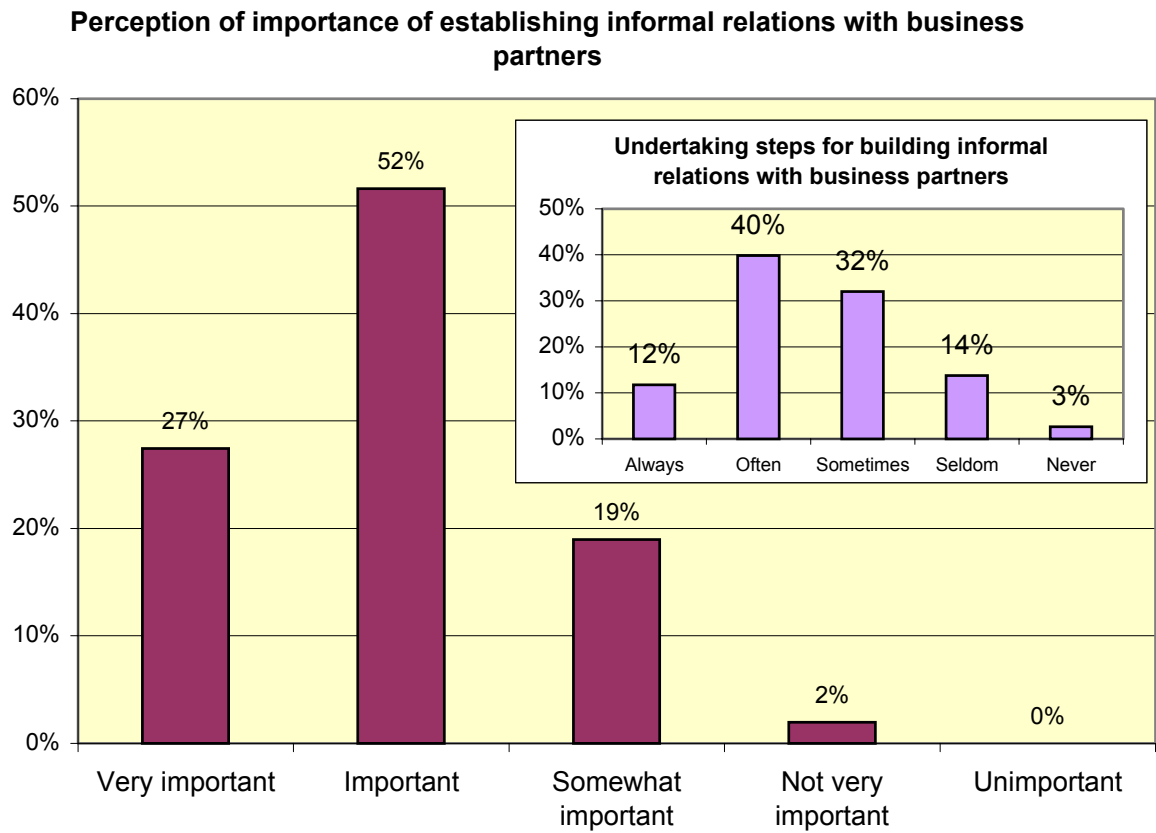
**"Entrepreneurs working in the Ukrainian small business often have to violate laws" (b)**



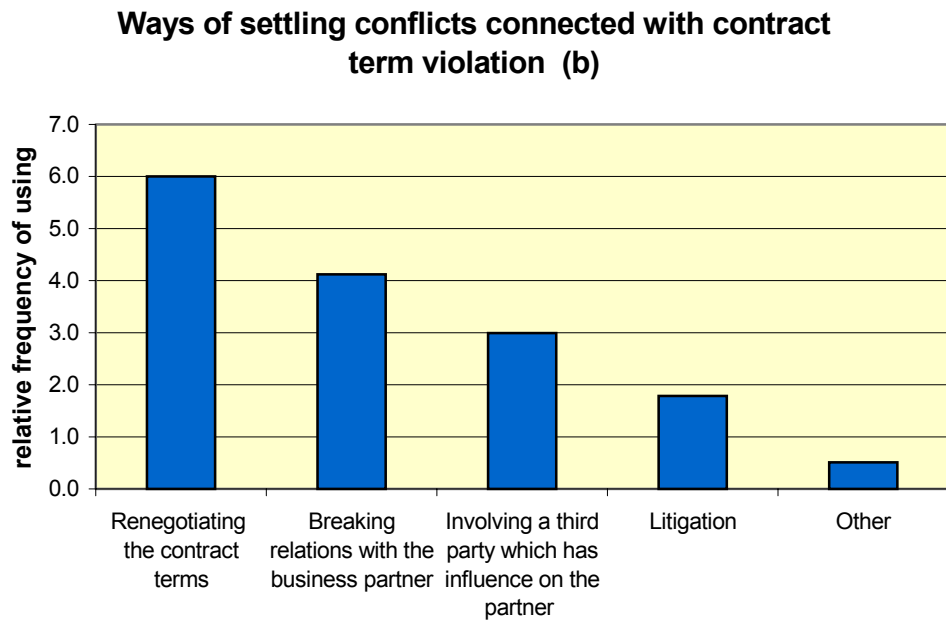
**"For Ukrainian entrepreneurs, retreating to 'shadow' is the only way to survive in business" (c)**



**Figure 2**

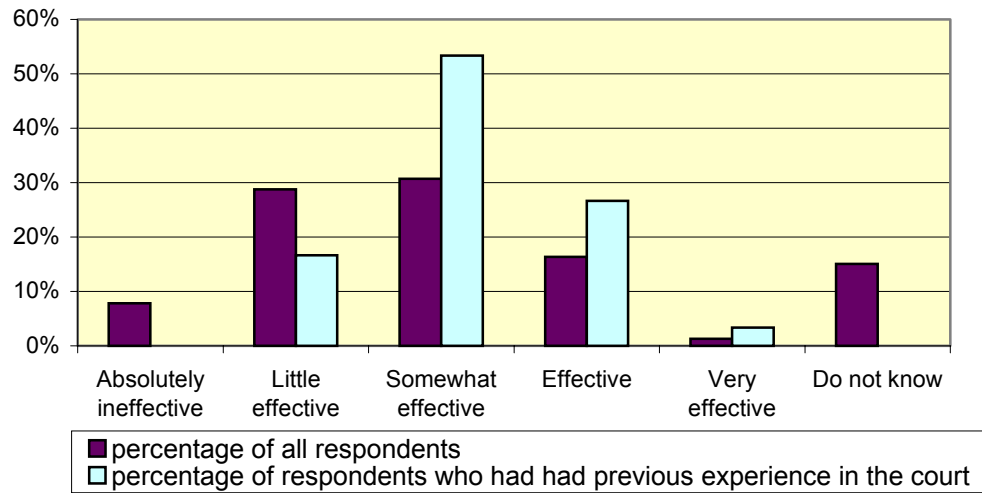


**Figure 3**

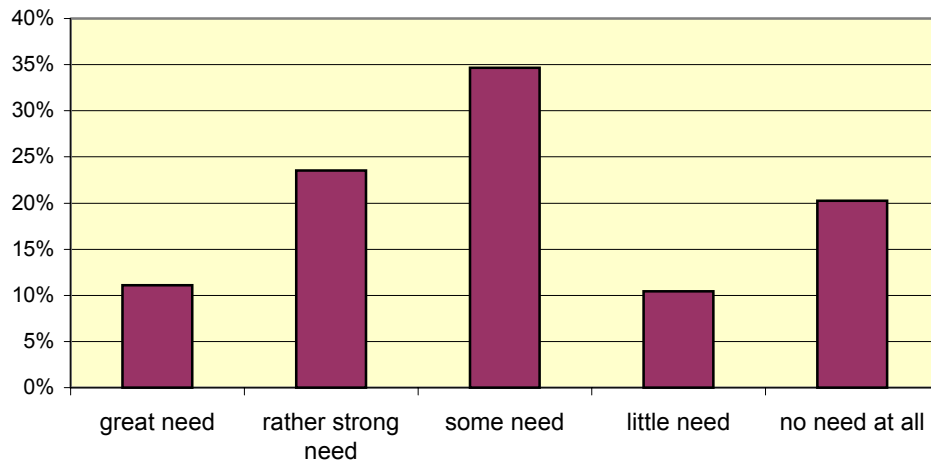


**Figure 4**

### Effectiveness of contract enforcement by legal procedures (a)



### Need for more effective legal support



**Figure 5**